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AUTHOR	Coronado, Julia Lynn; McIntosh, Susan Hume
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ABSTRACT

This study analyzed the impact tuition savings plans are likely to have on household savings. State-sponsored college savings programs rely mainly on tax incentives to motivate parents to save for their children's education in earmarked accounts. The first such programs were prepaid tuition plans, and other types of qualified tuition savings programs (QTSPs) have been developed. The current financial aid system provides powerful incentives for a significant number of families not to save in advance for education, both because families do not know in advance if a child will attend college and because the financial aid system poses a tax on parental assets. Because college savings plans reduce the tax on assets inherent in the financial aid system, they may increase savings for some households that are on the margin of eligibility. Still it appears that the introduction of QTSPs will not be likely to stimulate much participation among households with a great deal of uncertainty as to whether their children will attend college or who believe they will qualify for financial aid. In households that were planning to save for their children's education, the introduction of QTSPs implied a windfall gain in the form of reduced taxes, However, these households are likely to be in an early stage in the life cycle with low incomes and high expenses, and may spend the windfall and increase their consumption by more than the tax break. (SLD)

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Qualified Tuition Savings Programs: The Impact on Household Saving

Julia Lynn Coronado and Susan Hume McIntosh

2000

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QUALIFIED TUITION SAVINGS PROGRAMS: THE IMPACT ON HOUSEHOLD SAVING

Julia Lynn Coronado and *Susan Hume McIntosh*, Federal Reserve Board of Governors

POLICYMAKERS HAVE ALWAYS BEEN CONCERNED about household saving, but particularly so in the last seven years as the personal saving rate has plummeted (see Chart 1). The decline in personal saving raises two concerns. First, personal saving is an important source of national saving, which funds investment and fuels economic growth. Second, low personal saving raises the possibility that people are not preparing adequately for retirement or other future consumption needs. If significant numbers of people fail to save for retirement, they may rely increasingly on government programs already projected to be strained by the aging population.

To increase saving, particularly retirement saving, generous tax breaks are offered to employers and individuals who put money in earmarked retirement accounts. These tax incentives have succeeded in spurring tremendous growth in these accounts (private and public pension funds, IRAs, and annuities) to more than $12.5 trillion at the end of 1999, or more than a third of the financial assets of households. Whether these funds represent new household saving or saving shifted from other investment vehicles is the subject of an extensive and vigorous debate. Certainly, the personal saving rate does not reflect an increase in overall household saving.[1]

Another area of increasing concern for policymakers is saving by parents for the college education of their children. There is evidence that the returns to higher education in the form of higher wages have increased in recent years, and a well-educated workforce is considered an essential engine of future economic growth. While obtaining a college education is being given a higher priority, college tuition has increased at nearly twice the rate of general inflation since the early 1980s, raising concerns among parents that they will not be able to afford it. Another source of anxiety is that the proportion of debt-financed expenditures on higher education, as shown in Chart 2, has risen dramatically in recent years. More than 40 percent of outlays on higher education are now financed with student loans. Despite historically low default rates, the concern is that students are leaving college with excessive debt burdens. Tax breaks for interest paid on student loans have been put into place to ease the burden of servicing college debt.

State officials have tried to address the issues of rising college costs and increasing reliance on debt by implementing programs that encourage parents to save in advance for education. These programs offer attractive state tax incentives and collect the funds, and either manage them directly or select a professional investment firm. The federal government has facilitated the growth of these programs by offering federal tax breaks. These programs, referred to in this paper as qualified tuition savings programs (QTSPs), have gained in popularity among state officials, private money managers, and participants, with 47 states currently offering a program (see Table 1).

In this paper, we analyze the impact these programs are likely to have on household saving. We conclude that, while these programs are likely to grow rapidly in coming years, they probably will not spur significant new saving among households that did not save previously for college expenses, due to the incentives built into the federal financial aid program. The most likely participants in QTSPs are households that do not expect to qualify for financial aid and were planning to save for education in some form. For these households, QTSPs will not likely increase saving. Rather, the tax breaks built into QTSPs constitute a windfall gain that will more likely lead these households to increase consumption by spending the tax savings. National saving will decrease by shifting what would have been government saving into personal consumption.

OVERVIEW OF QUALIFIED PROGRAMS

State-sponsored college savings programs rely mainly on tax incentives to motivate parents to save for their children's education in earmarked accounts. The first such programs were prepaid tuition plans through which parents purchase contracts for future tuition at a state university at current prices.[2] Nineteen states offer prepaid tuition plans (see Table 1) in which tuition credits at a state university are purchased on behalf of a beneficiary.

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Chart 1: **NIPA Personal Saving Rate**

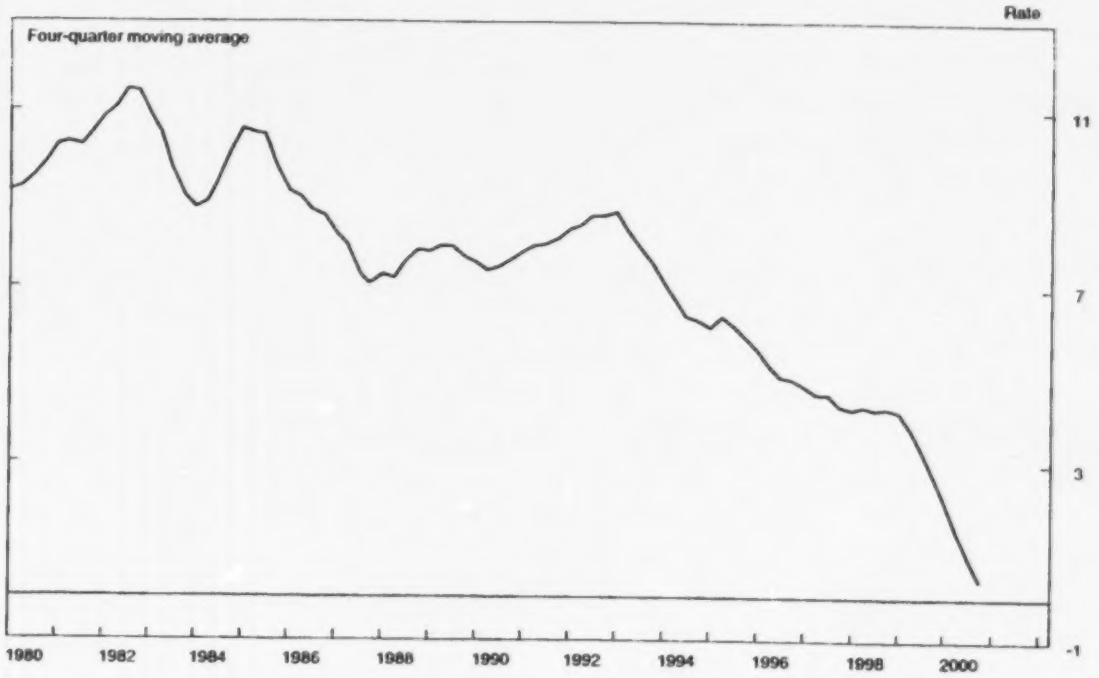
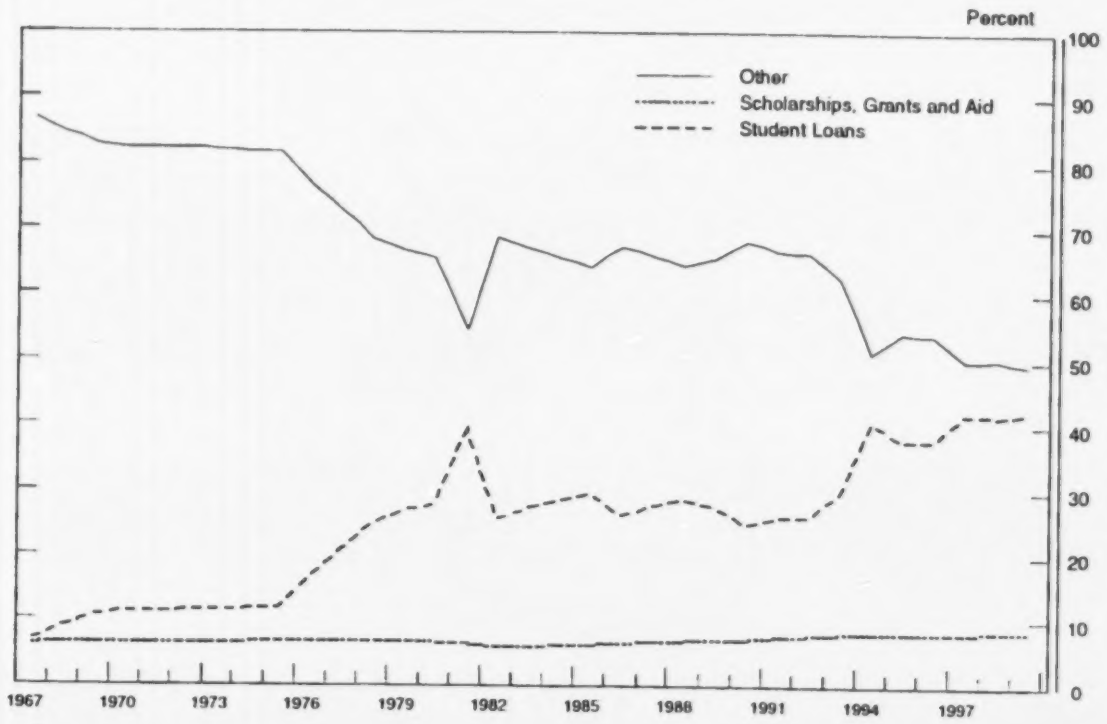


Chart 2: **Sources of Financing for Spending on Higher Education**



4

Table 1

State-Sponsored Qualified Tuition Savings Programs

State	*Type of Program*	*Date First Publicly Available*
Alabama	Prepaid	1990
Alaska	Hybrid	1991
Arizona	Savings	1997
Arkansas	Savings	1999
California	Savings	1999
Colorado	Prepaid / Savings	1997 / 1999
Connecticut	Savings	1998
Delaware	Savings	1998
Florida	Prepaid	1988
Georgia	Hope Scholarship	
Hawaii	Savings	2001
Idaho	Savings	Unavailable
Illinois	Prepaid	1998
Indiana	Savings	1997
Iowa	Savings	1998
Kansas	Savings	2000
Kentucky	Savings	1990
Louisiana	Savings	1997
Maine	Savings	1999
Maryland	Prepaid / Savings	1998 / 2001
Massachusetts	Prepaid / Savings	1995 / 1999
Michigan	Prepaid / Savings	1988 / 2001
Minnesota	Savings	2001
Mississippi	Prepaid / Savings	1997 / 2000
Missouri	Savings	1999
Montana	Savings	1998
Nebraska	No Program	
Nevada	Prepaid	1998
New Hampshire	Savings	1998
New Jersey	Savings	1998
New Mexico	Prepaid / Savings	2000 / 2000
New York	Savings	1998
North Carolina	Savings	1998
North Dakota	Savings	2000
Ohio	Prepaid / Savings	1989 / 2000
Oklahoma	Savings	2000
Oregon	Savings	2001
Pennsylvania	Prepaid / Savings	1993 / 2001
Rhode Island	Savings	1998
South Carolina	Prepaid	1998
South Dakota	No Program	
Tennessee	Prepaid / Savings	1997 / 2000
Texas	Prepaid	1996
Utah	Savings	1996
Vermont	Savings	1999
Virginia	Prepaid / Savings	1996 / 1999
Washington	Prepaid	1998
West Virginia	Prepaid / Savings	1998 / 2000
Wisconsin	Savings	1997
Wyoming	Savings	2000

Source: College Plans Savings Network

Generally, the beneficiary or the purchaser or both must be state residents. If a student decides to attend a private university or an institution in another state, payments equal to the value of the state tuition purchased are made to those institutions. If the beneficiary does not attend college, then the contract may be transferred to another beneficiary or be terminated and the funds withdrawn subject to a 10 percent penalty on investment earnings. Generally, the beneficiary must be at least age 18 before a contract can be terminated. These contracts may be purchased as a lump sum, or through monthly installments over a number of years. They do not have to be purchased by parents; anyone may purchase a contract on behalf of any beneficiary.

Michigan was the first state to sponsor a prepaid tuition plan in the mid-1980s. They battled the Internal Revenue Service for years and eventually won federal tax deferral of investment earnings until the beneficiary begins college, at which point investment earnings are taxed at the beneficiary's marginal tax rate. Contributions also qualify as a gift for estate tax purposes, and a lump sum of $50,000 may be contributed in any given year and the tax benefits spread over five years. States also generally offer limited tax deductibility of contributions in addition to deferral of state income taxes during the accumulation phase, and many offer permanent exemption of investment earnings from state income tax.

More recently, state-sponsored college savings plans have begun to overshadow prepaid tuition plans. Twelve states offer both a saving plan and a prepaid tuition plan and 28 states offer only a saving plan, with the vast majority having been established in the last four years (see Table 1). The difference between a savings plan and a prepaid tuition plan is akin to the difference between a defined contribution and a defined benefit pension plan. Whereas a prepaid tuition plan allows a purchaser to lock in future tuition, savings plans allow any amount of contributions up to a maximum accumulation, and whatever has been accumulated is what is available to pay for college tuition. Funds can be used at any public or private university in any state. Investments in savings plans are generally weighted more heavily toward equities than investments in prepaid tuition plans, at least early in a child's life.

Saving plans offer the same tax advantages as prepaid plans: limited state income tax deductibility of contributions, state deferral or exemption of income taxes on investment earnings, federal deferral of income taxes on earnings, taxation of earnings at beneficiary's rate, and qualification under estate gift tax rules. They have grown in popularity for several reasons. In 1996, Section 529 of the Internal Revenue Code was created with the aim of clarifying federal tax treatment of QTSPs. Section 529 broadened the definition of qualified higher education expenses to include not only tuition and fees, but also room and board, books, and supplies. Prepaid tuition plans are less well suited to issuing contracts that cover such a wide range of variable expenses. The flexibility of contributions and college choice, and the more aggressive investments in savings plans have also proven to be more appealing to participants. Savings plans are also more liquid, allowing withdrawal by the contributor at any time subject to the 10 percent penalty on earnings.

Assets in all QTSPs reached $7.2 billion at the end of 1999. Although this represents only 10 percent of total outlays on higher education in 1999, it represents a 40 percent increase in assets since June of last year. While prepaid plans are growing, the most rapid growth is in the savings plans. Federal legislation was proposed in 2000 to exempt investment earnings from federal taxation.

THE IMPACT OF QTSPS ON NON-SAVERS

The current financial aid system provides powerful incentives to a significant number of families *not* to save in advance for education. It does so for two distinct reasons. First, parents do not know when a child is born whether the child will attend college 18 years down the road. They may form a probability based on their own desires and education, and this probability may change over time as the child grows and goes through school. The presence of need-based grants, scholarships, and subsidized student loans provides insurance for the parent in case their child *does* attend college. This insurance is more valuable the greater is the uncertainty that the child will attend college and the lower is expected income (the greater the likelihood the child will qualify for significant amounts of aid).[3]

Second, the financial aid system imposes a significant tax on parental assets. Federal aid and most aid from colleges and universities is based on information from the Free Application for Federal

Student Aid (FAFSA). An expected family contribution is derived from information on family size, age of parents, current income, and assets. The current federal aid formula counts 12 percent of parental assets as available income. A progressive rate is applied to available income in calculating the expected family contribution, with the highest marginal rate at 47 percent. Thus, the annual levy on parental assets accumulated prior to a child entering college is as high as 5.6 percent (0.12*0.47) per year.

Table 2 shows the implicit tax rate on assets imposed by the financial aid system. As shown in the first column, a dollar of assets accumulated prior to a child entering college would grow to $1.33 after five years after taxes paid on interest income.[4] The impact of the financial aid formula on assets is shown in the second column. Assets are taxed at a rate of 5.6 percent per year and investment income at a rate of 47 percent per year in addition to the state and federal income taxes. Thus, a dollar accumulated prior to a child entering college becomes 86 cents at the end of five years. Households on the margin of eligibility for financial aid face a tax of nearly 47 cents on the dollar ($1.33 minus $0.86) on assets accumulated prior to the year the child enters college.[5] Feldstein (1995) found empirical evidence that the financial aid system reduces saving significantly among households eligible for financial aid. Most estimates indicate that approximately 75 percent of households are eligible for some type of aid under the federal formula. Thus a significant fraction of households may find it optimal not to save for their children's education and to borrow whatever funds are not met with financial aid. If a household does not qualify for subsidized student loans, other tax preferred avenues for borrowing exist, including tapping equity in a home or borrowing against a 401K plan.

Prepaid college tuition programs are taxed at 100 percent, that is, the assets accumulated in these vehicles count 100 percent toward meeting the expected family contribution. For those who have any expectation of qualifying for financial aid when their children begin college, the 100 percent tax on assets in prepaid tuition programs is a powerful disincentive to participation.

Assets in saving plans, on the other hand, are counted as parental assets. The third column of Table 2 shows that the tax incentives provided by college savings plans will offset the financial aid tax to some degree. The tax deductibility of contributions and the deferral of taxes on investment earnings imply that a family in the lowest marginal tax bracket could accumulate $1.23 in a college saving plan prior to a child entering college at the same cost as accumulating $1.00 in a non-tax-preferred investment. They will then face the taxes on assets and investment income imposed by the financial aid system, as well as paying taxes on investment earnings (at the beneficiary's rate) as they withdraw funds. The last row of the last column indicates that college savings plans reduce the tax to 32 cents on the dollar from 47 cents ($1.33 minus $1.01).

Because college savings plans reduce the tax on assets inherent in the financial aid system, they may increase saving for some households who are on the margin of eligibility. To the degree that there is uncertainty whether a child will attend college, participation in a college savings plan carries a risk over simply contributing more to a tax deferred retirement account and borrowing against that account as needed. The net effect of these forces will be different for different households.

THE IMPACT OF QTSPS ON SAVERS

Despite the likelihood of a negligible effect of the introduction of QTSPs on those who expect to

Table 2

Impact of the Financial Aid System on Assets

	Evolution of One Dollar of Assets		
Age of Child	*After Income Taxes on Interest*	*After Income Taxes on Interest/Financial Aid*	*After Taxes: Assets Accumulated in Section 529 Plan*
18	1.00	1.00	1.23
19	1.06	0.97	1.18
20	1.12	0.94	1.14
21	1.18	0.91	1.09
22	1.25	0.88	1.05
23	1.33	0.86	1.01

qualify for financial aid, the tax preferences built into most QTSPs and the favorable political climate point to the rapid growth of these programs. The most obvious and reliable source of this growth will be the participation of parents who are saving or were planning to save in advance for their children's education. These are most likely families who place a high probability on their children attending college and who have no expectation that they will qualify for financial aid. We estimate that, for these families, each birth year cohort represents an estimated $1 billion in current dollars in potential annual contributions. The details of our calculation are shown in Table 3.

The current average cost for tuition, room, and board, shown in the first row of the second column, is approximately $10,000 per school year. We assume that inflation is 3 percent per year and tuition inflation is 2 percent greater than general price inflation, or 5 percent, per year. We assume that parents begin saving in the first year of their child's life, and that they save to pay the average tuition, room, and board for five years. We assume further that parents desire to make the same real contribution in each year, including the five years that their child is attending college. As shown in the third column of the table, parents need to contribute approximately $2,300 in current dollars and these contributions grow each year with inflation.

In our calculation, parents pay the income taxes on their contributions and the income and capital gains taxes on their investment earnings out of current income. Their tax bill, shown for the lowest marginal tax-payer in column four and for the highest marginal tax payer in column five, grows as they accumulate assets and their investment income increases. Accumulated assets per household are shown in column six. We assume a 7 percent nominal return on assets. Assets peak at close to $98,000 when the child turns 18 and are then drawn down to close to zero as the child attends college.

The aggregate assets that accumulate on behalf of a one-year birth cohort are shown in column seven. There are a bit more than 3.7 million babies in each birth year cohort that reach one year of age. We assume that, consistent with current attendance rates, approximately 25 percent of each birth year cohort will attend college full time, and that 50 percent of their parents save in advance for college.[6] The first line of column eight shows that contributions on behalf of one birth-year cohort imply more than $1 billion in college saving under our assumptions, or $18 billion in annual contributions for all cohorts currently in the pipeline. Thus the growth potential for QTSPs is quite large. During the start-up period, the potential for contributions is augmented further as parents and grandparents contribute large amounts that have been accumulated in other investment vehicles.

Growth in contributions should eventually level off as the system matures and the ratio of beneficiaries attending college to those in the accumulation phase increases. Future growth would rise (decline) with birth rates, attendance rates, tuition inflation, and participation rates in QTSPs.

While the growth potential of QTSPs among families who save for college is considerable, it is not likely that contributions to these accounts will constitute new savings. For those who were saving for their children's college education, these accounts will more likely represent a windfall gain that will allow them to increase their lifetime consumption.

Chart 1 shows the reduction in taxes realized by households who switch their saving from a non-tax- deferred investment into a QTSP. The dark line represents the gains realized by a household facing a 39.6 percent marginal federal and a 5.75 percent state income tax rate. The lighter line indicates the gains for a household facing a 15 percent marginal federal and a 2 percent state income tax rate.[7] The windfall is of course highest for those facing the highest marginal rates. The tax break increases over time as the value of the deferral of taxes on investment earnings grows. It becomes negative after the child enters college and taxes are paid on the investment earnings at the beneficiary's rate. The net present value of this stream of tax breaks is nearly $12,000 for those facing the highest marginal tax rates and almost $4,500 for those facing the lowest marginal rates.

Households that have high expectations that their children will attend college and have no expectation of qualifying for financial aid are likely to have relatively high incomes. These households are not likely to be liquidity constrained and can borrow and save across the life cycle to smooth consumption. The tax breaks built into QTSPs will not affect the savings decisions of these households at the margin, but rather will amount to a windfall gain in lifetime wealth. How they choose to allocate their tax savings between consumption and saving will depend on the interaction between the timing of the tax breaks and the expected life cycle

Table 3

Estimated Contributions for College Saving without QTSPs (dollars)

Child's Age (1)	*Average Annual Tuition, Room and Board* (2)	*Annual Contributions for College Saving* (3)	*Total Taxes - Lowest Bracket** (4)	*Total Taxes - Highest Bracket* (5)	*Accumulated Assets per Household* (6)	*Aggregate Accumulated Assets (millions)* (7)	*Aggregate Annual Contributions (millions)* (8)
1	10,000	2,330	396	1,057	2,330	1,078	1,078
2	10,500	2,400	438	1,142	4,893	2,263	1,110
3	11,025	2,472	484	1,233	7,707	3,565	1,143
4	11,576	2,546	533	1,331	10,793	4,992	1,178
5	12,155	2,622	586	1,436	14,171	6,554	1,213
6	12,763	2,701	643	1,549	17,864	8,262	1,249
7	13,401	2,782	704	1,670	21,897	10,127	1,287
8	14,071	2,866	771	1,800	26,295	12,161	1,325
9	14,775	2,952	842	1,940	31,087	14,378	1,365
10	15,513	3,040	919	2,090	36,303	16,790	1,406
11	16,289	3,131	1,002	2,250	41,976	19,414	1,448
12	17,103	3,225	1,092	2,423	48,140	22,265	1,492
13	17,959	3,322	1,188	2,608	54,831	25,360	1,536
14	18,856	3,422	1,292	2,806	62,091	28,717	1,583
15	19,799	3,524	1,403	3,018	69,962	32,357	1,630
16	20,789	3,630	1,523	3,246	78,489	36,301	1,679
17	21,829	3,739	1,652	3,491	87,723	40,572	1,729
18	22,920	3,851	1,791	3,753	97,714	45,193	1,781
19	24,066	3,967	1,940	4,034	83,048	38,410	-11,131
20	25,270	4,086	1,770	3,752	66,194	30,615	-11,687
21	26,533	4,208	1,573	3,422	46,941	21,710	-12,272
22	27,860	4,334	1,345	3,039	25,055	11,588	-12,885
23	29,253	4,465	1,083	2,598	285	132	-13,529

*Calculations are for a Virginia resident. The lowest bracket household faces a 2 percent state and 15 percent federal marginal income tax rate. The highest bracket household faces a 5.75 percent state and 39.6 percent federal marginal income tax rate. Investment income is assumed to be 50 percent interest and dividends and 50 percent capital gains.

pattern of their income. Given the fact that incomes in general, and the incomes of high earners in particular, rise over the life cycle, and given that disposable income rises dramatically as children leave home, it is likely that households with young children will consume rather than save the tax break realized from participation in a QTSP.

CONCLUSIONS

The introduction of QTSPs will not likely stimulate much participation among households with a great deal of uncertainty as to whether their children will attend college or who believe they will qualify for financial aid. This is especially true for prepaid tuition programs whereby assets are taxed at 100 percent under the financial aid formula, but is also true of college savings plans in which assets are subject to a 31 percent tax. Many households will find it optimal not to save at all and then borrow any necessary funds that are not provided by financial aid. Many of these state programs are introduced with extensive education and marketing campaigns in the hopes of attracting people who are not saving for their children's education. The more many households learn about the costs of college and the existing programs to help meet those costs, however, the more they will learn about the complex financial aid system and their eligibility for assistance.

For households that were planning to save for their children's education, the introduction of QTSPs implies a windfall gain in the form of reduced taxes. Because the households realizing this gain are at a relatively early stage in the life cycle when incomes are low and expenses high, they are likely to consume the tax savings. Due to the fact that a household participating in a QTSP can save less to meet the given target amount of saving for college, it is possible that some households will increase their consumption by more than the tax break.

Notes

[1] See Bernheim (1999) and Engen, Gale and Scholz (1994) for a discussion of the impact of retirement saving incentives on household and national saving.

[2] In a prepaid tuition program, the state essentially bets that it will realize a rate of return at least as great as the rate of tuition inflation. Some programs are backed by legislative guarantees, so that state taxpayers assume the risk if the return is less than tuition inflation. In other states, the situation is more ambiguous as to who would bear the cost if there were a shortfall. In states without an explicit legislative guarantee, there is often the implicit backing of state officials (Olivas, 2000).

[3] The discussion parallels the much more extensive analysis of Hubbard, Skinnner and Zeldes (1995), who found that the presence of asset-based, means-tested social insurance programs encourage many households to accumulate no wealth.

[4] The calculation assumes a rate of return of 7 percent. All investment income is interest income taxed at the lowest marginal tax rate of 15 percent for federal and 2 percent for state income tax.

[5] These calculations assume that the gap between the family's expected contribution and the cost of education is met with grants and scholarships. In reality, much of this need may be met with subsidized student loans. Because parents (and children) bear some cost for these loans, the tax rates will be less than those outlined in the table. Feldstein (1995) estimated that a financial aid package consisting of 50 percent grants and 50 percent loans is equivalent to a grant worth 80 percent of the total aid package. In this case, the tax rate would be 80 percent of that discussed above.

[6] In the 1998 Survey of Consumer Finances, more than 50 percent of all households reported saving in the previous year. About 12 percent reported saving specifically for education.

[7] The state rates represent Virginia's top and bottom income tax brackets.

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